

forging the future one market at a time

securities lending
builds its presence
in asia

After enjoying a period of rapid acceleration in the late 1980s and early 1990s, lack of activity and continuing regulations from local governments seemed to have slowed the pace of growth for securities lending within the Asia Pacific region (APAC). However, interest and activity seem to have recently re-ignited as select markets begin to show signs of making progress toward an organized lending structure.

While regulations continue to restrict certain aspects of lending in countries such as Malaysia and Thailand, other Asia-region countries such as Hong Kong, Japan, Singapore and Korea are increasingly looking to securities lending. Whether due to increased pressure on asset managers to improve returns, continued globalization, or the natural evolution of growing markets, securities lending is doubtlessly continuing to evolve as a valuable component of both a sound and flexible investment strategy, and a developed marketplace.

Pioneering a Presence for Decades

JPMorgan has long recognized the rich potential of the APAC region. Lending securities for over 20 years, the firm

continues to build a local presence in Asia on a market-by-market basis. With its first office in Australia established in 1872, and operations in Hong Kong since the 1920s, today JPMorgan continues to expand its global reach in the region, supported by a truly local footprint. The firm has more than 6,500 employees in the region located in 24 offices in 15 countries, with the firm's Investment Bank, Treasury & Securities Services, Asset & Wealth Management, JPMorgan Partners and Global Treasury businesses particularly active.

From a securities lending perspective, JPMorgan Investor Services was a leader in taking a visionary view of the APAC markets. Its first lending activity in the region was in 1987 in Japan, well ahead of many of its competitors. Its recent pioneering activities in Taiwan and Korea serve to further embody the firm's role as an industry leader. In 2002, JPMorgan Information Services became the first agent lender to enter Korea, and in 2003, was the first to establish a synthetic lending structure in Taiwan for off-shore lenders.

Due Diligence is Key

Among the major considerations when entering into a new lending market is the due diligence necessary to determine if there is, in fact, demand for securities lending. An equally rigorous exploration of both regulations and counter-parties then follows and is vital to determining appropriate demand.

"There are certain elements that make markets desirable from a lending perspective," says David Brown, Securities Lending and Investment Products business executive, JPMorgan Investor Services Asia Pacific. "You want to see a degree of liquidity, as well as healthy levels of corporate activity, such as mergers and acquisitions, and convertible bond issuance." Additionally, favorable conditions must converge with other factors to make for a lending-friendly backdrop. "Demand must come together with the market itself recognizing that lending is desirable," Brown adds. Other factors include hedge funds recognizing opportunities in those markets, prime brokers looking to support those hedge funds, and available lenders like JPMorgan, who have the necessary supply of stock to lend on behalf of their clients, looking to go into those markets.

The local regulatory environment in many of APAC's markets is an especially important and often challenging factor as well. Local taxes, for example, can make lending transactions essentially uneconomic. "In some countries it's perfectly legal to lend, but taxes on transactions themselves, or on certain entitlements, together with increased operational burdens imposed on lending can make it unattractive," Brown says. Regulations can sometimes eliminate a market from the lineup of eligible countries. Perhaps the most important aspect of thorough due diligence in the region rests in terms of evaluating eligible counter-parties. "The importance of this cannot be overemphasized," says Avi Stein, Securities Lending and

revolved around the inadmissibility of a traditional lending structure, in that stock could not be delivered free of payment. However, by utilizing an innovative approach JPMorgan was able to gain approval for a non-standard product that facilitated a stock loan trade, placing Investor Services on the cutting edge of this new market.

"Markets that wish to be seen as forward-looking and progressive, and those that seek to put better practices in place, understand that it is important to offer securities lending," Lee explains. Most important, he says, securities lending in itself helps markets evolve and become more liquid and flexible, mainly by facilitating certain trading strategies and providing liquidity to the markets.

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Investment Products global business executive, JPMorgan Investor Services. Referring to the JPMorgan Investor Services' new Securities Lending venture in Taiwan, Stein explains, "We stress this point as much as we emphasize our excitement and comfort with the structure we've developed there, which helps to assure full, extensive due diligence with respect to counter-parties."

Stein emphasizes that clients should examine all aspects of a lending agent's due diligence operations in Asia before engaging in lending. "In markets such as Taiwan, where there is no formal lending structure in place for offshore participants, lenders have an even greater onus to determine that meticulous due diligence has been performed in regard to counter-parties," agrees Michelle Phillips, global head of trading, JPMorgan Investor Services. "Because our primary structure in Taiwan is a synthetic one, completely proprietary to JPMorgan, we offer the comfort of knowing that our firm is behind every loan, indemnifying the client against broker default, and backed by the extensive due diligence of any and all counter-parties that we perform."

First to Market in Korea

Despite the challenges and even obstacles to lending in select APAC markets, ingenuity and innovation can lead to client-focused solutions and actually overcome many of the barriers to lending. One of the most recent examples of that innovation lies in Korea, where JPMorgan was the first agent lender to enter that country's market in 2001.

"The Korean marketplace represented a lucrative opportunity for us," says Simon Lee, vice president Securities Lending, JPMorgan Investor Services Asia Pacific. "The high demand from hedge funds to borrow Korean equities to facilitate trading strategies, combined with limited supply, created significant opportunities for our clients."

Gaining approval for lending, however, was not accomplished without having to overcome some of the obstacles previously mentioned, the most notable of which

"For those markets that want to be players on the world stage and attract significant capital, an active securities lending arena is a virtual necessity," he says.

The Korean lending market has also proven to be an interesting case study of how a new market evolves. The early days of the market were notable for the lack of supply and the correspondingly high spreads. As time has passed, more participants have come to the market on both the lending and borrowing side of the business, and a degree of equilibrium has recently been in evidence. Lee adds that conditions currently point to favorable momentum as demand remains strong, despite greater liquidity (and therefore thinner spreads) of late. "The injection of supply through recent entrants to market in Korea — following JPMorgan's lead — allow us to manage our program, continuing to take great care in the prudent management of our clients' securities," explains Lee. Stein agrees, "We generally take a strategic approach when liquidity increases in markets, viewing it as an opportunity to make changes to our policies in order to further maximize opportunities and, ultimately, increase client income while shrewdly managing risk."

Taiwan Follows Suit

After witnessing Korea's successful entree into securities lending, Lee says that Taiwanese authorities looked to follow suit, and in 2003 moved to create an active lending market.

On June 30, 2003, the Taiwanese Securities and Futures Commission opened its door to Qualified Foreign Institutional Investors (QFIIs), permitting them to participate in the Taiwan Stock Exchange's (TSE) borrowing and lending system. While the breakthrough was regarded by many as a hopeful sign of increased global opportunities for lending, some industry participants believed that due to the previously restrictive nature of the TSE, it would be a while before a full-fledged securities lending program was up and running. In any case, it was clear that wide-

spread participation in Taiwan would require clarification of the current framework, fine-tuning, and in some cases revisions, particularly in regard to the treatment of corporate action entitlements, 'purpose' tests for loan eligibility and collateral requirements.

While the introduction of lending to a new market is not an immediate process in any of the world's regions, Taiwan, admittedly, worked swiftly to make lending a possibility. "To its credit," says Brown, "Taiwan moved very quickly compared to other markets. It has evolved from strictly local securities lending as recently as 2003. This allowed us to offer a loan-type product to our clients who want to borrow in the region."

Initially, Taiwan offered simply an on-shore lending market with all the attendant elements of the business in place. Still today, the Taiwanese lending market has a distinctively on-shore feel; Taiwanese-denominated collateral must be maintained on shore, and there are the usual local regulations, taxes and other legalities to consider. Only local participants, Taiwan-based brokerage houses and investors, and QFIIs are allowed to execute trades within the market. Lee explains, "Certain regulations mean that lending in Taiwan will not suit every investor." This includes strict regulations surrounding fails. "But for those clients who are alert to the additional requirements, there is the potential to realize material rewards," he says.

However, Lee points out that the existing market did allow JPMorgan Investor Services Securities Lending team to work with its borrowers to develop a synthetic lending structure, thereby creating a solution for clients who

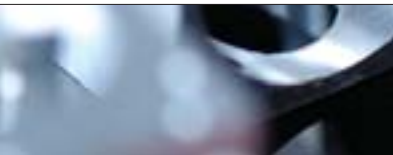
make it more acceptable to traditionally conservative lending clients. "Those clients who are extremely well-informed in regard to the lending arena," says Shellard, "and who are prepared to commit the time and effort involved in executing this type of transaction, stand to profit from this new and potentially lucrative opportunity."

"We have invested a substantial amount of time, money and research in developing a synthetic structure that is proprietary to JPMorgan Securities Lending in Taiwan," says Brown. Conducting a thorough assessment of eligible counter-parties is a major component of this effort. "This is essential to help protect our clients," he says, "and to help assure that clients who can work within our approved structure will have access to excellent potential income opportunities."

Stein adds, "What's exciting is that Taiwan represents a market in great demand right now due to a limited supply and a finite number of players with a viable structure in place." Another positive sign is the relative speed at which the TSE has moved to implement the current framework, perhaps driven by the success of what Korea achieved, which should auger well for the future.

"Whether it's looking at expansion into new markets in APAC, or adding new lenders in the region," Phillips says, "there are numerous growth opportunities in APAC, all of which form part of JPMorgan's strategic aims for the global securities lending business."

Lee sums up the securities lending environment in the region best, "Securities lending has been an accepted practice in the U.S. and Europe for some time now, and



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wanted to participate in the Taiwanese market outside of the onshore regime.

Essentially, a structured trade within the synthetic product affords a client the benefits of a lending transaction without actually making a loan. "In Taiwan, as in most other markets, there is a requirement for traders to hedge positions, particularly in convertible bonds, warrants and futures, and the like," explains John Shellard, global head of Equity Lending, JPMorgan Investor Services Securities Lending. "This requires borrowing the underlying equity. The new structure allows JPMorgan's clients to lend the equity for the hedge in return for a fee, thereby generating significant incremental revenue for the client," he explains.

"It's effectively a derivative transaction, where you buy the derivative and then turn it into a loan, retaining the revenue benefits of lending," he says. The synthetic structure, he adds, combines elements of both the derivative transaction and a loan. The combination of the two significantly changes the risk profile of the transaction in an attempt to

now the Asia Pacific region is following suit. With the potential revenue opportunities, increasingly major institutional investors in the region who aren't lending are asking themselves, why not?"

JPMorgan Investor Services continues to be actively involved in the development of the APAC region, primarily through the Pan Asian Securities Lending Association (PASLA), an association of firms that are active in the business of borrowing and/or lending securities of Asian markets. Says Lee, "Innovation, strict due diligence measures and the increasingly receptive macro environment all point to a substantial profit potential for those clients willing to participate in these new markets." ○○○

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